Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1996

KENNETH H. GUICE,

Petitioner,

-against-

CHARLES SCHWAB & CO., INC.,

Respondent.

FRANK J. EVANGELIST, JR.,

Petitioner,

-against-

FIDELITY BROKERAGE SERVICES, INC.,

Respondent.

Petition For Writ Of Certiorari To The New York State Court Of Appeals

PETITION FOR WRIT OF CERTIORARI

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16 pp

QUESTION PRESENTED

Do the Federal Securities Laws pre-empt traditional state damage remedies for violations of common law and statutory duties governing a broker's receipt of kickbacks when those duties parallel federal requirements?

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OPINIONS BELOW

The New York Court of Appeals decision is not yet officially reported. It is reproduced in the Appendix to this Petition for Writ of Certiorari ("A.") at 1. The New York Appellate Division decision in *Guice v. Charles Schwab & Co.* is reported at 214 A.D.2d 53 (1st Dep't 1995) (A. 25) and the New York Appellate Division decision in *Evangelist v. Fidelity Brokerage Servs., Inc.* is reported at 637 N.Y.S.2d 392 (App.Div. 1st Dep't 1996) (A. 27). The respective decisions by the New York Supreme Court (A. 29, 37) are not officially reported.

JURISDICTION

The New York Court of Appeals filed its opinion and entered judgment on October 17, 1996. (A. 1) This timely Petition for Writ of Certiorari is filed pursuant to Supreme Court Rule 13. This Court has jurisdiction pursuant to 28 U.S.C. § 1257(a).

28 U.S.C. § 2403(b) may apply because this case involves the constitutionality of New York statutes. Therefore, petitioners have served a copy of this Petition on the New York Attorney General pursuant to Supreme Court Rule 29.4(c).

STATUTES AND REGULATIONS INVOLVED

This Petition for Writ of Certiorari raises the question whether the 1934 Securities Exchange Act, as amended,

and the regulations of the Securities and Exchange Commission pre-empt state common law and statutory remedies available to investors. Due to their length, the statutes and regulations involved are reproduced in pertinent part in the Appendix. (A. 49). Those statutes and regulations are as follows:

1. The Supremacy Clause of the United States Constitution, Article VI, clause 2.
2. Section 11A of the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78k.
3. Section 28 of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb.
4. Section 18 of the Securities Act of 1933, 15 U.S.C. § 77r (1996).
5. Rule 10b-10, Confirmation of Transactions, 17 C.F.R. § 240.10b-10 (promulgated 1977).
6. Rule 11Ac1-3, 17 C.F.R. 240.11 Ac1-3 (promulgated November 2, 1994).
7. New York Penal Law § 180.05.
8. New York General Business Law § 352-c.

STATEMENT OF THE CASE

These virtually identical class actions question the practice of the defendant brokers of routing their customers' orders to dealers who pay the brokers kickbacks in exchange for their business. The brokers neither pass the kickbacks along to their customers nor do they adequately disclose to them their utilization of the practice, which they euphemistically call "payment for order

flow". The complaints allege that the defendants' conduct constitutes a breach of fiduciary duty, breach of contract, violations of New York law prohibiting commercial bribery and violation of the New York statute regulating the conduct of securities brokers (the Martin Act). As the cases progressed, the issues were narrowed, with plaintiffs' agreement, to limit plaintiffs' claims to damages only in situations where "full and frank disclosure" had not been made by defendants (A. 4-5), thus paralleling federal law.

In each case, the defendant moved to dismiss the complaint on the theory that the action was pre-empted by federal law. In each case, the New York Supreme Court granted the defendant's motion and the plaintiff appealed. In each case, the dismissal was reversed by a unanimous Appellate Division, and both defendants appealed to the New York Court of Appeals. The reversal of the Appellate Division decisions by the New York Court of Appeals is the subject of this Petition for Certiorari.

REASONS FOR GRANTING THE WRIT

In reaching its decision, the New York Court of Appeals has decided an important question of the relationship of state and federal power in a way that directly conflicts with relevant decisions of this Court.

The New York Court of Appeals ruled that state actions for damages resulting from the corrupt practice of payment for order flow are pre-empted by federal law. The Court's decision is inconsistent with a long line of

decisions by this Court. In particular, in holding that "civil damage actions" would interfere with Congressional objectives (A. 15), it completely ignores the holding in this Court's most recent pre-emption decision, *Medtronic, Inc. v. Lohr*, 116 S. Ct. 2240 (1996), which specifically recognizes the viability of traditional state damage remedies for violations of state duties when those duties parallel federal requirements.

The issue of pre-emption of state regulation of order flow was presented to this Court for certiorari in *Dahl v. Charles Schwab & Co., Inc.*, 117 S. Ct. 176 (1996), and this Court did not grant the writ. However, this Court's decision in *Medtronic* came after the Minnesota court's decision in *Dahl*. It is clear that *Medtronic* set the standard for pre-emption determinations and one would expect that subsequent adjudications would follow *Medtronic* rather than the state court decision in *Dahl*. However, the New York court chose to completely ignore *Medtronic* and relied instead on *Dahl*. (A. 19). Unless this Court reviews the instant decision, a major transfer of power from the states to the federal government will result, and investors will be left without a remedy.

I. THE FEDERAL STATUTORY SCHEME OF SECURITIES REGULATION DOES NOT PRE-EMPT STATE CLAIMS FOR DAMAGES FOR SIMILAR OR IDENTICAL CONDUCT PROHIBITED BY FEDERAL LAW

Section 28 of the Securities Exchange Act, 15 U.S.C. § 78bb, carefully describes those very limited areas where

states shall not tread.[1] In all other areas, the statute provides, "The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity." A clearer expression by Congress of its decision that state claims such as are asserted here are not pre-empted would be hard to envision. Indeed, the Supreme Court has stated, "The section was plainly intended to protect, rather than to limit, state authority." *Leroy v. Great W. United Corp.*, 443 U.S. 173, 182 (1979). *See also Matsushita Elec. Indus. Co. v. Epstein*, 116 S. Ct. 873 at 882 (1996):

> Congress plainly contemplated the possibility of dual litigation in state and federal courts relating to securities transactions. *See* 15 U.S.C. § 78bb(a) (preserving "all other rights and remedies that may exist at law or in equity"). And all that Congress chose to say about the consequences of such litigation is that plaintiffs ought not obtain double recovery.

The New York court treated Section 28 as though it were not in the statute. (A. 23). It also ignored the Congressional amendment of Section 18 of the Securities Act of 1933 which shortly preceded its decision. That amendment clarified Congress' long standing view that state law remedies in the securities field were not pre-empted by federal regulation unless Congress specifically so ordained:

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[1] States are limited in the types of securities transfer taxes they may impose. Section 28(d).

> (c) *Preservation* of Authority. –
>
> (1) Fraud authority. – Consistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or *unlawful conduct by a broker or dealer, in connection with securities or securities transactions.*

15 U.S.C. 77r (1996) (emphasis supplied).

The 1975 amendments to the Securities Exchange Act of 1934, while authorizing the SEC to promote a national market system, say nothing at all about the pre-emption of state law. As this Court has noted in the *Medtronic* case and elsewhere, if such pre-emption were the congressional aim, it would have been simple enough for Congress to so state.

Moreover, nothing in the SEC regulations pre-empts state regulation or even gives a blessing to payment for order flow. On the contrary, Rule 11Ac1-3 prohibits payment for order flow without full and adequate disclosure. Rule 11 Ac1-3 provides:

> (a) no broker or dealer acting as agent for a customer may effect any transaction . . . unless such broker or dealer informs such customer, *in writing, upon opening a new account* and on an annual basis thereafter, of . . . (1) *The broker's or dealer's policies regarding receipt of payment for order flow* . . . including a statement as to whether any payment for order flow is received for routing customer orders and *a detailed description of the nature of the compensation received*; and (2) The broker's or dealer's *policies*

> *for determining where to route customer orders that are the subject of payment for order flow. . . .*

17 C.F.R. § 240.11Ac1-3 (emphasis added). The federal standard thus parallels the state duties sought to be enforced in the complaints.

Nor is payment for order flow blessed by SEC Rule 10b-10 which deals with statements on confirmations. *See* 17 C.F.R. § 240.10b-10 ("The requirements under this section that particular information be disclosed is not determinative of a broker-dealer's obligation under the general antifraud provisions of the federal securities laws to disclose additional information to a customer at the time of the customer's investment decision").

Footnote 28 of the 1977 SEC Exchange Act Release [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,143, at 87,930 (May 5, 1977) accompanying Rule 10b-10 states:

> The rule does not attempt to set forth all possible categories of material information to be disclosed by broker-dealers in connection with a particular transaction in securities.[2]

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[2] *See also*, Note, *The Perils of Payment for Order Flow*, 107 Harv. L. Rev. 1675, 1685 (May 1994) (disclosures on confirmation slips do not justify broker retention of order flow payments because "the vague, small-print disclosure required by Rule 10b-10 does not adequately alert customers to the presence of payments for order flow" and "ex-post acquiescence is not the ex-ante agreement that agency law seems to mandate before the agent can keep profits derived from a transaction on behalf of his principal"). *Heaphy v. Kerr*, 180 N.Y.S. 542, 545, 190 A.D. 810, 813 (1920), *aff'd*, 232 N.Y. 525, 134 N.E. 557 (N.Y. 1921) ("No one has reason to expect that in the mere notice of the purchase of stock the broker is inveigling him into some further contract. . . . ").

The SEC has, in fact, never endorsed payment for order flow. Its general view is that state law claims are not pre-empted by the federal securities laws:

> Ordinarily, a fiduciary that uses the assets of its managed accounts for its own benefit would be subject to claims of a breach of fiduciary duty *under state and federal law.*

SEC, U.S. Equity Market Structure Study, [1992 Tr. Binder] Fed. Sec. L. Rep. CCH ¶ 85,012 at p. 82,908 n.7 (July 14, 1992) (emphasis supplied).[3]

In short, the federal regulation of payment for order flow is consonant with the relief sought in the complaint. Moreover, as the Appellate Division stated in *Evangelist v. Fidelity Brokerage Servs., Inc.*, 637 N.Y.S.2d at 393, referring

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[3] Lest the attitude of the SEC be described as benign, SEC Chairman Arthur Levitt has been quoted as criticizing order flow payments for their "potential to reduce competition based on published quotes." *The Wall Street Journal*, December 15, 1995, page C1. The New York and American Stock Exchanges have also criticized the practice. The American Stock Exchange stated, through its Chairman:

> The Exchange strongly urges the ban of cash payment for order flow, because such practice reduces overall market liquidity and undermines effective price discovery. Payment for order flow represents a serious conflict of interest in that it undermines the broker's obligation to seek best execution of customer orders.

(Hearings Before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce, House of Representatives, 103rd Cong., 1st Sess., 12 (April 14, 1993)). *See also*, letter dated December 9, 1993 from the New York Stock Exchange to the SEC, SEC File No. 07-29-23, at 2-3.)

to the October 2, 1995 effective date of the SEC rule, "Even assuming that federal law now authorizes payment for order flow, it did not do so retroactively."[4]

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[4] Three lower federal courts have considered the identical issue in removed cases involving payment for order flow. All three have held that there is no federal jurisdiction in such cases and have remanded them to the state courts. *Gilman v. Wheat, First Sec.*, 896 F. Supp. 507 (D. Md. 1995); *Dumont v. Charles Schwab & Co.*, C.A. No. 95-0606 Section "A", 1995 U.S. Dist. LEXIS 5992 (E.D. La. May 3, 1995); *Thomas v. Charles Schwab & Co., Inc.*, C.A. No. 95-0307 Section "A", 1995 U.S. Dist. LEXIS 12007 (W.D. La. July 12, 1995) (cited in *Gilman v. Wheat, First Sec.*, 896 F. Supp. at 512).

The *Dumont* court began its pre-emption analysis by reciting the applicable standard and the matters that were not in dispute:

> State law is displaced by federal law where (1) Congress expressly preempts state law; (2) Congressional intent to preempt is inferred from the existence of a pervasive regulatory scheme; or (3) state law conflicts with federal or interferes with the achievement of federal objectives. Since 15 U.S.C. § 78bb(a) (Supp. 1994) specifically provides that "[t]he rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity," neither express preemption nor a pervasive federal regulatory scheme can be seriously argued.

1995 U.S. Dist. LEXIS 5992 at *9 (citations omitted). The court went on:

> Where as here, Congress has not explicitly or implicitly displaced all state regulation in a specified field, preemption arises only if compliance with both federal and state law is an impossibility or when the state law is an obstacle to the accomplishment of the purpose of the federal scheme. Although applying the Louisiana standard of fiduciaries to a national

II. THE NEW YORK COURT IGNORED AND THUS CONTROVERTED THIS COURT'S HOLDING THAT AN IDENTICAL FEDERAL REQUIREMENT IN A FIELD SUBJECT TO TRADITIONAL STATE REGULATION DOES NOT PRE-EMPT STATE COMMON LAW DAMAGE RELIEF

The New York Court of Appeals concluded that plaintiffs' "causes of action, even as limited by plaintiffs as being based solely on inadequate or absent disclosure of receipt of order flow payments, are pre-empted by the 1975 amendments to the Securities Exchange Act and

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> brokerage company such as Schwab may require a stricter standard of care to its customers, *the application of Louisiana law does not conflict with the SEC's authority and power to regulate the securities industry, and compliance with both federal regulations and the stricter Louisiana standard of care is not impossible. Moreover, since greater disclosure could benefit the investor, the application of Louisiana law may indeed serve the basic purpose of federal laws and regulations.*

Id. at *11 (emphasis added).

And in *Gilman v. Wheat, First Sec., Inc.*, 896 F. Supp. at 512, the court held:

> As to securities law, it is "well settled that federal law does not enjoy complete preemptive force in the field of securities." *Baker, Watts & Co. v. Miles & Stockbridge*, 876 F.2d 1101, 1107 (4th Cir. 1989). *Cf. Dumont v. Charles Schwab & Co.*, 1995 U.S. Dist. LEXIS 5992 (E.D.La. May 3, 1995) (finding no complete preemption of plaintiff's state law challenge to payment for order flow and remanding to state court, *Thomas v. Charles Schwab & Co.*, No. 95-0307 (W.D.La. July 12, 1995) (same). Thus, this court does not have federal question jurisdiction over this case.

implementing SEC regulations." (A. 5). The Court "reject[ed] plaintiffs' contention that there is no pre-emption here because compliance with State common-law disclosure standards under agency doctrine would not prevent compliance with SEC regulatory disclosure requirements . . . " (A. 19). *Quoting International Paper Co. v. Ouellette*, 479 U.S. 481, 494 (1987), the Court stated:

> Even if the goals of federal and state law are the same, "[a] state law also is pre-empted if it interferes with the methods by which the federal statute was designed to reach this goal."

A. 19.

In reaching this result, the New York court completely ignored this Court's decision in *Medtronic, Inc. v. Lohr*, 116 S. Ct. 2240 (1996), which had been brought specifically to its attention. In *Medtronic*, this Court specifically held that an identical federal requirement in a field subject to traditional state regulation does not pre-empt state common law relief simply because that state relief involves the awarding of damages not available under federal law:

> Nothing in § 360k denies Florida the right to provide a traditional damages remedy for violations of common-law duties when those duties parallel federal requirements.

Medtronic, 116 S. Ct. at 2255.

III. APPLICATION OF STATE LAW IS NOT PRE-EMPTED BY FEDERAL LAW

The standard for determining whether a federal statute has a pre-emptive effect with respect to state laws or common law causes of action is a strict and narrow one. As articulated by this Court in *Florida Lime and Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142 (1963), the doctrine of pre-emption may not be invoked unless either "the nature of the regulated subject matter permits no other conclusion, or . . . Congress has *unmistakably* so ordained." (emphasis added). This Court later expanded upon this principle in *New York State Dep't of Social Services v. Dublino*, 413 U.S. 405, 415 (1973), when it stated:

> We reject, to begin with, the contention that pre-emption is to be inferred merely from the comprehensive character of the federal . . . provisions. . . . The subjects of modern social and regulatory legislation often by their very nature require intricate and complex responses from the Congress, but without Congress necessarily intending its enactment as the exclusive means of meeting the problem.

The Court in *Dublino* quoted with approval language contained in a prior decision: *Schwartz v. Texas*, 344 U.S. 199, 202-03 (1952):

> If Congress is authorized to act in a field, it should manifest its intention clearly. It will not be presumed that a federal statute was intended to supersede the exercise of the power of the state unless there is a clear manifestation of intention to do so. The exercise of federal supremacy is not lightly to be presumed.

And just last term the Court held that, absent a conflict that frustrates the accomplishment and execution of the full purposes and objectives of Congress, there is no federal pre-emption of state law. *Freightliner Corp. v. Myrick*, 115 S. Ct. 1483 (1995).

Other recent decisions in this Court have, in cases not as strong as the present, construed provisions argued to be pre-emptive in light of the presumption against the pre-emption of state regulation and found that, particularly in traditional areas such as the regulation of securities brokers, state actions were not pre-empted. *Cipollone v. Liggett Group*, 505 U.S. 504 (1992); *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987); *Nader v. Allegheny Airlines*, 426 U.S. 290 (1976).

The decision of the court below, if allowed to stand, would deprive investors of their traditional right to recover from a broker who has cheated them.

CONCLUSION

Petitioners respectfully ask this Court to issue a Writ of Certiorari in order to resolve the important questions of federalism and pre-emption raised by the decision of the New York Court of Appeals.

Respectfully submitted,

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State of New York
Court of Appeals

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1 No. 200

Kenneth H. Guice,

Respondent,

v.

Charles Schwab & Co., Inc.

Appellant.

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1 No. 201

Frank J. Evangelist, Jr.,

Respondent,

v.

Fidelity Brokerage Services, Inc.,

Appellant.

OPINION

This opinion is uncorrected and subject to revision before publication in the New York Reports.

No. 200:
Catherine A. Ludden, for appellant.
Richard M. Meyer, for respondent.
Securities Industry Association, amicus curiae.

No. 201:
A. Robert Pietrzak, for appellant.
Richard M. Meyer, for respondent.

LEVINE, J.:

The plaintiffs in these appeals are former retail customers of defendants Charles Schwab & Co., Inc.

(Schwab) and Fidelity Brokerage Services, Inc. (Fidelity). Schwab and Fidelity are "discount" stock brokerage houses, operating nationwide, who charge reduced commissions for effecting securities transactions for their clientele and hold themselves out as offering quicker executions of orders on behalf of customers who have already decided upon what securities to buy or sell. Plaintiffs have brought these class actions on behalf of all similarly-situated (unrestricted by geographical location) clients of the defendants who used their brokerage services during the 1990-1994 putative class period.

In their respective complaints, which are identical in all pertinent respects, plaintiffs seek a return of commissions, compensatory and punitive damages, an accounting and injunctive relief based on common-law theories of breach of fiduciary duty and conversion arising out of the agent/principal relationships between defendants and the putative class members, and upon alleged statutory violations.[1]

All of the plaintiffs' causes of action arise out of defendants' receipt of what is known in the securities industry as "order flow payments." The practice of order flow payment consists of remuneration in the form of monetary or other benefits given to retail securities broker-dealers for routing customers' orders for execution to wholesale dealers or other market makers in the subject securities. Paying for order flow originated many years ago in the over-the-counter (OTC) market, when

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[1] At the time Supreme Court dismissed each of these actions, neither had yet been certified as a class action.

regional broker-dealers were paid a fee by wholesale market makers in the OTC security bought or sold, for directing orders to them for execution.[2] With the advent of computer technological advances capable of providing an entirely automated market system independent of the floor of any stock exchange (such as the National Association of Securities Dealers Automated Quotation [NASDAQ] System), and automated trading systems permitting accelerated execution of orders by regional exchange specialists, OTC market makers and member firms of the regional stock exchanges could compete for orders in listed stocks with the national New York and American Stock Exchanges.[3] Thus, routing orders in listed stocks to OTC market makers and regional exchange specialists has more recently become a major source of order flow payments to retail broker-dealers.[4]

Plaintiffs' complaints allege that the defendants' acceptance of order flow payments breached the fiduciary relationship between, them and their customers in the

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[2] Payment For Order Flow, SEC Exchange Act Release No. 34-33026 (Oct. 6, 1993), *reprinted in* 58 Fed Reg 52934, 52935-52936; Facciolo and Stone, *Avoiding the Inevitable: The Continuing Viability of State Law Claims in the Face of Primary Jurisdiction and Preemption Challenges Under the Securities Exchange Act of 1934*, 1995 Colum Bus Law Rev 525, 640 (hereinafter cited as "Facciolo and Stone").

[3] Securities and Exchange Commission Division of Market Regulation, *Market 2000, An Examination of Current Equity Market Developments*, at 8-9 (1994).

[4] SEC Exchange Act Release No. 34-33026, *supra*, 58 Fed Reg, at 52936.

plaintiff member classes under common-law agency principles. Plaintiffs also allege that the acceptance of order flow payments itself is illegal and actionable because it violates a broker's duty to obtain the "best execution" (i.e., execute the transaction under the most favorable possible terms) of its customers' orders. They also allege illegality of the acceptance of order flow payments as a form of commercial bribery (citing Penal Law § 180.05) and a violation of state securities law (the Martin Act) (citing General Business Law § 352-c).

Schwab and Fidelity moved to dismiss the complaints on grounds, *inter alia*, that enforcing plaintiffs' state common-law and statutory causes of action would violate the United States Constitution's Commerce Clause (US Const, art I, § 8) and Supremacy Clause (*id.*, art VI, cl 2), and interfere with the primary jurisdiction of the Securities and Exchange Commission (SEC). In each case, the complaint was dismissed by Supreme Court under the Supremacy Clause, on the ground that plaintiffs' causes of action were pre-empted by the Securities Exchange Act of 1934, as amended, and the SEC Regulations promulgated thereunder.

The Appellate Division modified in each case (*Guice v. Charles Schwab & Co.*, 214 AD2d 53; *Evangelist v. Fidelity Brokerage Services, Inc.*, ___ AD2d ___ [Feb. 6, 1996]). The Court in *Guice* noted that plaintiff "as limited by his brief, does not seek to bar totally the practice of payments for order flow, 'except where, as here, "full and frank disclosure" has not been made' " (214 AD2d, at 55). The Court concluded that, upon that basis, plaintiff Guice's causes of action were not pre-empted by federal law and that the primary jurisdiction doctrine was not a bar.

Accordingly, the Court reinstated all of plaintiff's causes of action (except that based upon the Martin Act) and remitted to Supreme Court to determine the remaining grounds for defendant's motion to dismiss. The subsequent decision of the Appellate Division in *Evangelist* largely followed the reasoning of the court in *Guice*.[5] The Appellate Division granted Schwab and Fidelity leave to appeal in each case upon the certified question of whether its order of modification was properly made.

We reverse, concluding that the plaintiffs' remaining common-law causes of action, even as limited by plaintiffs as being based solely on inadequate or absent disclosure of receipt of order flow payments, are pre-empted by the 1975 amendments to the Securities Exchange Act and implementing SEC regulations.

The Supremacy Clause of the United States Constitution, directing that federal laws "shall be the supreme Law of the Land * * * any Thing in the Constitution or Laws of any State to the Contrary notwithstanding" (US Const, art VI, cl 2), thereby vests in Congress the power to supersede not only state statutory or regulatory law but common law as well (*see, Freightliner Corp. v. Myrick*, ___ US ___, 115 S Ct 1483, 1487; *International Paper Co. v. Ouellette*, 479 US 481, 496). The pre-emption question is ultimately one of congressional intent (*see, Barnett Bank of Marion County v. Nelson*, ___ US ___, 116 S Ct 1103, 1107; *California Fed. Sav. & Loan Assn. v. Guerra*, 479 US 272, 280). As recapitulated most recently in Barnett Bank

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[5] Thus, similarly, all of Evangelist's causes of action except the Martin Act claim were reinstated.

(*supra*, ___ US, at ___, 116 S Ct, at 1107-1108), congressional pre-emptive intent may be shown from express language in the federal statute; it may also be established implicitly because the federal legislation is so comprehensive in its scope that it is inferable that Congress wished fully to occupy the field of its subject matter ("field pre-emption"), or because state law conflicts with the federal law. Implied conflict pre-emption may be found when it is impossible for one to act in compliance with both the federal and state laws or when "the state law * * * 'stan[ds] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress' " (*id.* at 1108, quoting *Hines v. Davidowitz*, 312 US 55, 67; *City of New York v. Job-Lot Pushcart*, 88 NY2d 163, 170).

Moreover, federal administrative agency regulations, promulgated pursuant to congressional delegation of discretionary quasi-legislative authority to effectuate congressional purposes, may also pre-empt state law (*see, Capital Cities Cable, Inc. v. Crisp*, 467 US 691, 699-700). "When the administrator promulgates regulations intended to pre-empt state law, the court's inquiry is * * * limited: 'If [his choice represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute, we should not disturb it unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned' " (*Fidelity Fed. Sav. & Loan Assn. v. de la Cuesta*, 458 US 141, 154, quoting *United States v. Shimer*, 367 US 374, 383 [brackets in the original]).

The potential collision here of plaintiffs' state law causes of action with federal law arises out of the 1975 amendments to the Securities Exchange Act of 1934 (*see,*

Pub L 94-29, 89 US Stat 97, *codified at* 15 USC § 78, *et seq.*) and the implementing regulations of the SEC. The 1975 amendments were enacted in response to a congressional perception of "the securities industry's languor in the face of great change and great opportunity" (Sen Rep No. 94-75, Senate Committee on Banking, Housing and Urban Affairs, 94th Cong, 1st Sess 1, *reprinted in* 1975 US Code Cong & Admin News 179, 180 [summarizing the 1973 Securities Industry Study Report of the Subcommittee on Securities]). Congress identified the causes of that languor to include "price fixing [of] commission rates; artificial * * * [and] unjustified barriers to access to markets and market makers; opposition to market integration from powerful vested interests; * * * [and] the absence of effective control of market developments and operations by the Securities and Exchange Commission" (*id.*).

Thus, Congress concluded that new legislation was necessary whereby "the SEC is granted broad and flexible authority to shape *a new market system* adequate to the needs of investors in this country and around the world" (*id.*, at 2, 1975 US Code Cong & Admin News, at 180-181 [emphasis supplied]). The bill was designed to give the SEC power to "eliminate all unnecessary or inappropriate burdens on competition," "pursue the goal to centralized "trading of securities" and "provide leadership for the development of a *more coherent* and rational regulatory structure to correspond to and to police effectively the new *national* market system" (*id.*, 1975 US Code Cong & Admin News, at 181 [emphasis supplied]).

Accordingly, to the original Securities Exchange Act's enumerated reasons for requiring regulation of the securities industry, the 1975 amendments added the necessity

"to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions" (Pub L 94-29, § 2, 89 US Stat, at 97, *codified at* 15 USC § 78b). Congress made specific findings that it was in the public interest to assure "economically efficient execution of securities transactions; [and] fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets" (*id.*, § 7, 89 US Stat, at 111-112, *codified at* 15 USC § 78k-1[a][1][C][i], [ii]).

Under the 1975 amendments, the SEC was "directed, therefore, having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to use its authority under this chapter to facilitate the establishment of a national market system for securities * * * and to carry out the objectives set forth in paragraph (1) of this subsection [15 USC § 78k-1(a)(1), quoted above]" (*id.*, 89 US Stat, at 112, *as codified at* 15 USC § 78k-1[a][2]).

Congress also authorized implementing regulations to "assure the prompt, accurate, reliable, and fair collection * * * [and] distribution * * * of information with respect to * * * transactions in such securities and the *fairness* and *usefulness* of the form and content of such information" (*id.*, 89 US Stat, at 115, *codified at* 15 USC § 78k-1[c][1][B] [emphasis supplied]).

Acting under the foregoing legislative directions and delegation of authority, in 1977 the SEC adopted Rule 10b-10, regarding information to be disclosed on customers' confirmation statements upon the execution of

customers' orders. The disclosure requirements of Rule 10b-10 were proposed by the SEC as "a *uniform* rule applicable to all who wish to effect transactions for or with investors" (Securities Confirmations Proposed Rule, SEC Exchange Act Release No. 12806 [Sept. 16, 1976], *reprinted in* 41 Fed Reg 41432, 41432 [emphasis supplied]). The SEC decided the nature and extent of such disclosure by "adjust[ing] regulatory requirements to eliminate those for which compliance costs appear to be disproportionate to the practical benefits of investor protection thereby obtained" (*id.*). Thus, as originally adopted, Rule 10b-10 contained a requirement that on a customer's confirmation statement the broker-dealer disclose "whether any other remuneration [other than the amount received from the customer and certain specified sources] has been or will be received and that the source and amount of such other remuneration will be furnished upon written request" (Securities Confirmations, SEC Exchange Act Release No. 34-13508 [May 5, 1977] [announcing adoption of Rule 10b-10], *reprinted in* 42 Fed Reg 25318, 25323, *codified as amended at* 17 CFR 240.10b-10[a][7][iv]).

Federal Regulation of Order Flow Payments

The SEC has monitored and studied securities industry assessments of the practice of order flow payments for over a decade (SEC Exchange Act Release No. 34-33026, *supra*, 58 Fed Reg, at 52935). The agency conducted a round table discussion on the subject in 1989 (*id.*). The SEC consistently applied the confirmation statement remuneration disclosure mandate of the original Rule 10b-10 to order flow payments (Release No. 34-33036,

supra, 58 Fed Reg, at 59936-37 ["Thus, Rule 10b-10 currently requires a broker-dealer to indicate specifically if it is receiving payments for order flow in connection with a particular trade."]). It is uncontested that Schwab and Fidelity complied with the applicable disclosure requirements of then Rule 10b-10 on the confirmation statements they sent to all of the putative plaintiff class members here.

In 1993, the SEC proposed to amend and add to its disclosure regulations in order to address with more particularity the practice of order flow payments (SEC Exchange Act Release No. 34-33026, *supra*). The SEC's decision-making process entailed the same interest balancing and cost/benefit analysis as was utilized in initially adopting Rule 10b-10. The SEC reviewed the potential detrimental effects of order flow payments, including potential conflicts of interest between customer and broker (Release No. 34-33036, *supra*, 58 Fed Reg, at 52936), possible breach of duty of best execution of orders under common-law agency principles and possible commission of commercial bribery under federal and state law (*id.*, 58 Fed Reg, at 52937-52939, 52941). Thus, the agency recognized that there were critics who advocated drastic restrictions on order flow payments, if not outright elimination of the practice (*id.*, 58 Fed Reg, at 52941).

Conversely, the SEC's 1993 proposed rulemaking on order flow payments recognized that the securities industry gained economic advantages from the practice, which ultimately benefitted the investor public (*id.*, 58 Fed Reg, at 52939-52940).

The SEC rejected any extreme approach in favor of a proposed rule to expand disclosure of the receipt of order flow payments. The agency proposed to amend Rule 10b-10: (1) to include a broad definition of the practice itself, that would also cover various commonly employed forms of nonmonetary remuneration; and (2) to require confirmation statement disclosure of the receipt of order flow payments and the specific dollar "amount of any monetary payment, discount, rebate or reduction of fee" received (Release No. 34-33026, *supra*, 58 Fed Reg, at 52940). Additionally, the SEC proposed a new Rule 11 Ac1-3 to require disclosure on each new customer's account statement and annually thereafter as to the broker-dealer's policies concerning the receipt of order flow payments and annual disclosure of the aggregate dollar amount of such payments, rebates, etc. (*id.*, 58 Fed Reg, at 52940). The agency invited comment on its proposal and upon more drastic alternative regulation of order flow payments, including outright elimination of the practice or requiring dealers to pass onto customers the order flow payment received (*id.*, 58 Fed Reg, at 52941-42).

Approximately a year later, the SEC announced adoption of its final rule for regulation of order flow payments (Payment For Order Flow, SEC Exchange Act Release No. 34-34902 [Oct. 27, 1994], *reprinted in* 59 Fed Reg 55006).[6] It explained that it rejected elimination of

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[6] In pertinent part the final rule added a new paragraph (9)(e) (defining payment for order flow), added a new subparagraph (a)(7)(iii) (governing disclosure of order flow payment at confirmation), and added a new Rule 11Ac1-3

order flow payments entirely because the practice did not necessarily violate a broker-dealer's best execution obligation, and that the practice benefitted the securities industry in lowering execution costs, in facilitating technological advances in retail customer order handling practices and in enhancing competition among broker-dealers and the various exchange and nonexchange securities markets and, thus, also worked to the advantage of investors (*id.*, 59 Fed Reg, at 55007-55011). The SEC also noted the serious enforcement problems that elimination of the practice would entail and the drastic impact that an outright ban would have on the securities industry (*id.*, 59 Fed Reg, at 55011).

The SEC's 1994 final rule regulating the practice of order flow payments largely followed the disclosure requirements it had proposed a year earlier. However, the agency – again employing cost/benefit analysis – eliminated the proposed disclosure requirements that confirmation statements and annual account statements show dollar amounts received for order routing. The SEC was apprehensive that mandatory disclosure of specific monetary receipts might be "unworkable" (*id.*, Fed Reg 59, at 55010) and would, at the least, impose "an extreme burden" upon broker-dealers "to determine the amounts received from each order in time for a confirmation" and would entail expenses disproportionately high in relation

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(governing disclosure on customer account statements). These changes were codified respectively at 17 CFR 240.10b-10(a)(9)(e), (a)(7)(iii), and 17 CFR 240.11Ac1-3. Additionally, former subparagraph (a)(7)(iii) of Rule 10b-10 – the original confirmation statement remuneration requirement – was redesignated subparagraph (a)(7)(iv).

to the potential benefits to customers (*id.* 59 Fed Reg, at 55010 n 39).

Pre-Emption Analysis As Applied to Plaintiff's Common-Law Agency Causes of Action

Pre-emption analysis must begin with a description of the nature of plaintiffs' causes of action and whether they represent colorable claims from which liability could be imposed. In this Court, as before the Appellate Division, plaintiffs have abandoned their statutory and common-law claims based on the per se illegality of defendants' receipt of order flow payments. Instead, plaintiffs rely exclusively on allegations in their identical complaints that Schwab and Fidelity violated their common-law agency relationships with customers comprising the putative plaintiff classes. Specifically, they allege that Schwab and Fidelity breached their common-law duties, owed to each member of the plaintiff classes, of undivided loyalty under which they were limited to acting in any stock transaction solely in the interest of each firm's principal.

Plaintiffs allege that the acceptance by defendants of order flow payments, which they characterize as "kickbacks," violated the agency relationship with each class member because customers' orders were accepted and routed "without full and frank disclosure" of each defendant's dual role in the transaction, which disclosure "to be effective must lay bare the truth, without ambiguity or reservation, in all its stark significance" (Complaints, ¶ 8). Plaintiffs aver that defendants' disclosures to the members of the class were inadequate (rendering their

duel role and self-dealing actionable) in failing to inform the "class members *prior to* the execution of any transaction that [defendants] would be receiving a kickback, let alone the *amount* thereof" (Complaints, ¶ 9). They allege that the disclosure on the customers' confirmation statements (in compliance with then Rule 10b-10[a][7][iii]), that remuneration was received and would be further described upon request, "falls far short of the full and frank disclosure required by law" (*id.*).

Plaintiffs' allegations of the standard of disclosure which must be made by an agent, having a personal interest in the principal's transaction *prior* to the execution of the transaction, has support in New York agency law precedents. Indeed, plaintiffs plead verbatim this Court's articulation of an agent's obligation to make a full and complete disclosure of any conflict of interest in a transaction conducted for the principal:

> Disclosure * * * indefinite and equivocal does not set the agent free to bargain for his own account or for the account of a corporation which acts through him alone. If dual interests are to be served, *the disclosure to be effective must lay bare the truth, without ambiguity or reservation, in all its stark significance* (*Wendt v. Fisher*, 243 NY 439, 443 [Cardozo, J.] [emphasis supplied]; *see also, TPL Associates v. Helmsley-Spear, Inc.*, 146 AD2d 468).

In such conflict of interest situations, the Restatement (Second) of Agency states that advance disclosure by the agent is required of "all facts which the agent knows or should know would reasonably affect the principal's judgment" whether to consent to the agent's dual role

(Restatement [Second] of Agency, § 390 and comment a, at 208-209). Thus, facially, plaintiffs have pleaded actionable claims under New York common-law agency principles, and similar claims could have been brought in the courts of other States who subscribe to the views of the Restatement (Second) of Agency. And a jury could have found against Schwab or Fidelity under these principles because no specific pre-transaction disclosure of defendants' receipt of order flow payments was made, nor of the dollar amounts of such payments to be received in the transaction, which disclosure might have affected the judgment of the customers.

Upon the basis of the legislative history of the 1975 amendments to the Securities Exchange Act and the history of SEC's implementing regulations applicable to order flow payment disclosure, we are convinced that permitting the courts of each State to enforce the foregoing common-law agency standards of disclosure on the practice of order flow payments in civil damage actions would unavoidably result in serious interference with the "accomplishment and execution of the full purposes and objectives of Congress" (*Hines v. Davidowitz, supra,* 312 US, at 67), in enacting the 1975 amendments, and would directly conflict with SEC regulations limiting the disclosure requirements regarding receipt of order flow payments to less exacting, post-transaction information on customer confirmation statements and disclosure of general policies of the broker on initial and annual customers' account statements.

As we have shown, the 1975 amendments to the Securities Exchange Act were intended to give the SEC the power administratively to develop a "coherent and

rational regulatory structure to correspond to and to police effectively the new national market system" (Sen Rep No. 94-75, at 2, *supra*, 1975 US Code Cong & Admin News, at 181). Among the goals of Congress in that legislation was to spark the creation of such a national market system for security trading, which would assure more "economically efficient execution of securities transactions" and promote greater competition among all securities industry players, including competition "between exchange markets and markets other than exchange markets" (Pub L 94-29, § 7, 89 US Stat, at 111-112, *codified at* 15 USC § 78 k-1[a][1][C], *supra*). The SEC was directed administratively to promote those goals. Congress also recognized that its objectives would require SEC regulation of disclosures regarding security transactions, including "the fairness and usefulness of the form and content of such information" (*id.*, 89 US Stat, at 115, *codified at* 15 USC § 78 k-1[c][1][B], *supra*).

Acting pursuant to that delegated authority, the SEC fashioned customer disclosure requirements applicable to the receipt of order flow payments in 1977 under the original Rule 10b-10, and in 1994 by amendments to Rule 10b-10 and the adoption of new Rule 11Ac1-3. In each instance, the agency determined the nature and extent of the disclosure requirements, based on an interest-weighing, cost/benefit analysis. In applying the former Rule 10b-10 disclosure requirements to order flow payments and in specifically addressing the practice in its 1994 rulemaking on the subject, the SEC recognized that order flow payments further the purposes of Congress by enhancing more efficient and less costly execution of customers' orders and by promoting competition for

order-executions among all markets, with demonstrated beneficial results for individual investors.

Permitting the courts of each State to impose civil liability on national securities brokerage firms, such as Schwab and Fidelity, for failure to meet more stringent common-law agency standards of disclosure of receipt of order flow payments (rather than the federally-mandated *uniform* specific disclosure on post-transaction confirmation statements and general disclosure on new customer account statements and annual statements, under the SEC's amended Rule 10b-10 and Rule 11Ac1-3) would inevitably defeat the congressional purpose of enabling the SEC to develop and police that "coherent regulatory structure" for a national market system. Securities broker-dealers, confronted with the risk of nation-wide class action civil damage liability, including restitution of commissions and punitive damages – as plaintiffs seek here – would be impelled to tailor their disclosures to each State's common-law agency jurisprudence, and the carefully-crafted SEC disclosure requirements would have little, if any, influence.[7] Surely, "[i]t is unlikely – to say the least – that Congress intended to establish such a chaotic regulatory structure" (*International Paper Co. v. Ouellette, supra*, 479 US, at 497).

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[7] Securities industry representatives expressed to the SEC their apprehension of exposure to liability if common-law agency principles were allowed to prevail over SEC uniform disclosure requirements (*see, e.g.*, 1990 Letter to Secretary, SEC from Andrew M. Klein, Schiff Hardin & Waite [July 5, 1990]), quoted in Facciolo and Stone, *supra*, 1995 Colum Bus L Rev, at 657 n 410; *see also*, SEC Exchange Release No. 34-33026, *supra*, 58 Fed Reg, at 52938-52939).

When, thus, a State's regulation, through the imposition of common-law tort liability or otherwise, adversely affects the ability of a federal administrative agency to regulate comprehensively and with uniformity in accordance with the objectives of Congress, "then the state law may be pre-empted even though 'collision between the state and federal regulation may not be an inevitable consequence' " (*Schneidewind v. ANR Pipeline Co.*, 485 US 293, 310, quoting *Northern Natural Gas Co. v. State Corp. Commn. of Kansas*, 372 US 84, 91-92).

State civil actions based upon common-law agency doctrine would thwart the objectives of Congress in a second respect. As already noted, the SEC determined that the practice of order flow payments brings about constructive results furthering the goals of Congress in the 1975 amendments to the Securities Exchange Act. It also found that stricter disclosure requirements than those ultimately adopted under its rules might be unworkable or costly out of all proportion to possible benefits to investors. Thus, the SEC rejected proposals for more exacting disclosure, anticipating that, at the least, the increased cost of such disclosure would be passed onto customers in higher commissions or to market makers in higher fees for order routing – outcomes clearly counterproductive to congressional objectives of economically-efficient execution of orders, lower execution costs and vigorous competition among OTC and exchange markets. At worst, onerous stricter disclosure costs plus the threat of lawsuits all around the country, based on breach of common-law agency relationships, would likely result in many brokerage firms abandoning acceptance of order flow payments altogether, an even

more drastic undermining of congressional objectives. Thus, for these reasons, we agree with the Minnesota Supreme Court's conclusion in *Dahl v. Charles Schwab & Co.* (545 NW2d 918, 925, *cert denied* 65 USLW 3085 [Oct. 7, 1996]), that these likely deleterious if not ruinous effects upon a securities industry practice the SEC, under its delegated securities industry supervisory powers has determined will further the policies of Congress, are alone sufficient to require pre-emption (*see, Capital Cities Cable, Inc. v. Crisp*, 467 US 691, 707-708, *supra*). Put another way, the SEC, acting reasonably within its rule-making authority, adopted a policy, incorporated in regulations, of permitting the practice of order flow payments and not unduly inhibiting the practice by oppressive disclosure requirements. These goals and policies of the SEC are "antithetical to threshold limitations placed" on order flow payment practices in the form of severely, if not prohibitively, burdensome additional disclosure requirements imposed by application of each State's common-law of agency in civil damage actions (*Doctor's Assocs., Inc. v. Casarotto*, ___ US ___, ___, 64 USLW 4370, 4372 [May 20, 1996]).

We reject plaintiffs' contention that there is no pre-emption here because compliance with State common-law disclosure standards under agency doctrine would not prevent compliance with SEC regulatory disclosure requirements, and because greater disclosure promotes the same investor-protection purposes of the federal regulations. Even if the goals of federal and state law are the same, "[a] state law also is preempted if it interferes with the methods by which the federal statute was designed to reach this goal" (*International Paper Co. v. Ouellette*, 479

US, at 494, *supra*). The stricter standards of order flow payment disclosure which may be required under State common-law agency principles inevitably will supplant the disclosure rules of the SEC on the same subject and come to dominate the relationship between broker and customer, since the broker would not be able to avoid civil liability for acceptance of order flow payments merely by complying with federal regulations.

Unquestionably, however, state common-law standards for disclosure when an agent has a financial stake in a transaction effected on behalf of a principal are set generally, and would be applied to broker-dealer receipt of order flow payments, without engaging in the policy choices and balancing of the competing legitimate interests of investors, exchange and nonexchange markets and other participants in the securities industry, that the SEC was charged by Congress to perform and that are involved in regulation of order flow payments. Thus, although both state common-law actions and federal regulations may promote broker-dealers' disclosure to customers, state enforcement of agency law standards of disclosure cannot help but upset the policy-based delicate balance Congress directed the SEC to achieve in the regulatory regime envisaged under 1975 amendments to the Securities Exchange Act. Here, as in *International Paper Co. v. Ouellette* (*supra*) (where state common-law nuisance actions also threatened to upset a federally-designed, legislative/regulatory interest-weighing cost/benefit approach). "[i]t would be extraordinary for Congress, after devising an elaborate [balanced regulatory] system that sets clear standards, to tolerate common-law suits that have the potential to undermine this regulatory

structure" (*id.*, 479 US, at 497; *see also, Gordon v. New York Stock Exchange*, 422 US 659, 688-690; *Darling v. Mobil Oil Corp.*, 864 F2d 981, 987-988).

The Effect of Securities Exchange Act § 28(a) on the Pre-emption Issue

Plaintiffs contend that any inference of pre-emptive intent by Congress under the 1975 amendments to the Securities Exchange Act is negated by the "savings" clauses incorporated in the statute by section 28(a) of the Act (15 USC § 78bb[a]). That section provides that the Exchange Act's rights and remedies are "in addition to any and all other rights and remedies that may exist at law or in equity," and that the Act does not "affect the jurisdiction of [state securities regulatory bodies] over any security or any person *insofar as it does not conflict* with the provisions of this chapter or the rules and regulations thereunder" (emphasis supplied). We conclude that section 28(a) does not foreclose the implied conflict pre-emption we find here. First, the legislative history of section 28(a) indicates that its purpose was to "leave the States with as much leeway to regulate securities transactions as the Supremacy Clause would allow them in the absence of such a provision," and particularly, "to save state blue-sky laws from pre-emption" (*Le Roy v. Great Western United Corp.*, 443 US 173, 182 n 13 [describing the testimony of the principal draftsman of the Exchange Act in Senate hearings on the legislation]).

Substantially similar savings clauses have been interpreted as only negating implied *field* pre-emption, but not conflict pre-emption, leaving the courts to determine

when any given state regulation is impliedly pre-empted because it prevents compliance with the federal law or the full achievement of congressional objectives (*International Paper v. Ouellette, supra,* 479 US, at 492-494; *see also, Edgar v. MITE Corp.,* 457 US 624, 631 [plurality opinion construing Securities Exchange Act § 28[a]).

Finally, the Supreme Court in *Freightliner Corp. v. Myrick* (___ US ___, 115 S Ct 1483, *supra*), held that inclusion of an express provision in a federal statute dealing with the pre-emption issue may support an inference negating implied pre-emption, but this "does not mean that the express clause entirely forecloses any possibility of implied pre-emption" (*id.,* at ___, 115 S Ct, at 1488). Any inference negating implied pre-emption was completely overcome here because, as we have demonstrated, enforcement of state common-law duties of disclosure under its agency jurisprudence not only would have "the potential," but would inevitably "undermine [the finely-crafted and balanced federal] regulatory structure" (*International Paper Co., supra,* 479 US, at 497).

Accordingly, in each action the order of the Appellate Division should be reversed, the complaint dismissed, and the certified question answered in the negative, with costs.

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Nos. 200 & 201: Order reversed, with costs, defendant's motion to dismiss the complaint granted and certified question answered in the negative. Opinion by Judge Levine. Chief Judge Kaye and Judges Simons, Titone, Bellacosa, Smith and Ciparick concur.

Decided October 17, 1996

214 A.D.2d 53 printed in FULL format.

Kenneth H. Guice, Appellant, v. Charles Schwab & Co., Inc., Respondent.

54819

SUPREME COURT OF NEW YORK, APPELLATE DIVISION, FIRST DEPARTMENT

214 A.D.2d 53; 630 N.Y.S.2d 317; 1995 N.Y. App. Div. LEXIS 8657

August 10, 1995, Decided

August 10, 1995, ENTERED

COUNSEL:

Richard M. Meyer of counsel, New York City (Milberg Weiss Bershad Hynes & Lerach, attorneys), for appellant.

Catherine A. Ludden of counsel, New York City (John E. Failla on the brief; Morgan, Lewis & Bockius, attorneys), for respondent.

JUDGES: Ellerin, J. P., Wallach, Nardelli and Mazzarelli, JJ., concur.

OPINION BY: Kupferman, J.

OPINION: [*54]

[**318] Kupferman, J.

In this class action seeking damages and injunctive relief against defendant, a discount brokerage firm, the issue presented is whether plaintiff's complaint, seeking injunctive relief and damages under various State law theories as [***3] the result of defendant's practice of

directing its customers' orders to certain market makers in return for cash and nonmonetary payments for such "order flow", violates the Supremacy Clause and Commerce Clause of the United States Constitution and would interfere with the pervasive Federal regulatory scheme and the primary jurisdiction given to the Securities and Exchange Commission (SEC) over matters affecting the national securities markets.

We disagree with the IAS Court that the present case, a common-law tort action to determine the reasonableness of the industry-wide practice of payment for order flow, would be absolutely inconsistent with the Federal regulatory scheme in light of the SEC's monitoring of the situation for the purpose of regulation. We also note that the Minnesota case cited by the court with approval has been reversed on appeal (*Dahl v Charles Schwab & Co., 524 NW2d 742*, review granted ___ NW2d ___ [Feb. 14, 1995] [Minn.]). In so ruling, the Minnesota Court of Appeals found that there was no conflict between Minnesota law and Federal law concerning the regulation of order flow payments and also found no Federal preemption inasmuch [***4] as Congress had passed no statute dealing directly with order flow payments and, at the time that case was argued, the SEC had not promulgated any final regulations regarding the receipt of order flow payments (*524 NW2d 742, 744-745*, supra). It did not reach the issue of whether Minnesota law would be preempted when the then-proposed SEC rule 11Ac1-3 (17 CFR 240.11Ac1-3) and the amendment to SEC rule 10b-10 (17 CFR 240.10b-10) took effect (supra, at 745, n 3); their effective date has since been delayed from April 3, 1995 to October 2, 1995 (Release No. 35473, *60 Fed Reg 14366*).

[*55] Here, as in *Dahl* (*supra*) there is no specific conflict between New York statutory or common law and the new regulations and no provision of the Securities Exchange Act of 1934 or the rules promulgated thereunder explicitly displaces State law with respect to the practice of payments for order flow. (See, Stone & Facciolo, Outside Counsel, Order Flow Cases: Jurisdiction, Preemption [**319] and Securities Laws, NYLJ, May 9, 1995, at 1, ___ col 1, at 4, col 6.)

It is settled that preemption of state law by federal statute or regulation is not favored absent persuasive reasons either that [***5] the nature of the regulated subject matter permits no other conclusion, or that Congress has unmistakenly so ordained, although the issue of preemption would still arise if compliance with both the Federal and State law is impossible or where the State law is an obstacle to the accomplishment of the purposes of the Federal scheme (*Florida Avocado Growers v Paul, 373 US 132, 142-143;* see also, *Freightliner Corp. v Myrick, 514 US ___, 115 S Ct 1483*).

As in *Nader v Allegheny Airlines* (*426 US 290*), in which a common-law tort action alleging fraudulent misrepresentation for the airline's failure to disclose to a customer its deliberate overbooking policy was permitted to proceed despite the fact that the Civil Aeronautics Board monitored the practice but did not disapprove of it, plaintiff, as limited by his brief, does not seek to bar totally the practice of payments for order flow, "except where, as here 'full and frank disclosure' has not been made . . . and then only to the extent the relief sought is available." Here, it appears that the SEC had the opportunity to bar completely the order flow practice and was

clearly aware of the existence of common-law remedies, [***6] but sought neither to ban the practice nor to comment upon or suggest preemptive legislation.

Although the IAS Court did not discuss primary jurisdiction, that doctrine should not bar plaintiff's action inasmuch as there is no mechanism for referral of plaintiff's claims to the SEC and its particular expertise is not required with respect to his claims (see, Reiter v Cooper, 507 US ___, ___, *113 S Ct 1213, 1220*).

Finally, in partially reinstating the complaint we remand the matter to the IAS Court to determine the remaining grounds for defendant's motion to dismiss plaintiff's remaining claims inasmuch as such issue has not been briefed or presented for our review. We note however plaintiff's admission [*56] below that there is no private right of action under the Martin Act (General Business Law § 352-c; see, *CPC Intl. v McKesson Corp., 70 NY2d 268*) and his third cause of action was, therefore, properly dismissed.

Accordingly, the order of the Supreme Court, New York County (Beatrice Shainswit, J.), entered October 7, 1994, which granted defendant's motion to dismiss the complaint, should be modified, on the law, that part of defendant's motion [***7] seeking dismissal on Federal preemption and primary jurisdiction grounds should be denied and the matter should be remanded for determination of the remaining grounds for defendant's motion. As so modified, the order should otherwise be affirmed with respect to the third cause of action, without costs.

Ellerin, J. P., Wallach, Nardelli and Mazzarelli, JJ., concur.

Order, Supreme Court, New York County, entered on or about October 7, 1994, which granted defendant's motion to dismiss the complaint, unanimously modified, on the law, that part of defendant's motion seeking dismissal on Federal preemption and primary jurisdiction grounds denied, and the matter remanded for determination of the remaining grounds for defendant's motion. With respect to the third cause of action, the order, as so modified, is otherwise affirmed, without costs.

637 N.Y.S.2d 392 printed in FULL format.

Frank J. Evangelist, Jr., Plaintiff-Appellant,
-against- Fidelity Brokerage Services, Inc.,
Defendant-Respondent.

56552

SUPREME COURT OF NEW YORK,
APPELLATE DIVISION, FIRST DEPARTMENT

637 N.Y.S.2d 392; 1996 N.Y. App. Div. LEXIS 975

February 6, 1996, ENTERED

NOTICE: [*1] THE LEXIS PAGINATION OF THIS DOCUMENT IS SUBJECT TO CHANGE PENDING RELEASE OF THE FINAL PUBLISHED VERSION.

COUNSEL: For Plaintiff-Appellant: R.M. Meyer.

For Defendant-Respondent: A.R. Pietrzak.

JUDGES: Sullivan, J.P., Rosenberger, Wallach, Ross, Williams, JJ.

OPINION: Judgment, Supreme Court, New York County (Ira Gammerman, J.), entered January 25, 1995, granting defendant's motion to dismiss the complaint, unanimously modified, on the law, to deny the motion except as to the third cause of action, and, except as thus modified, affirmed, without costs or disbursements.

This is an appeal from the dismissal of a class action by plaintiff, a customer, alleging that defendant, a discount securities broker, in violation of New York State statutory and common law, received payments, called "order flow payments" from market makers for placing its orders with them. According to plaintiff, defendant's practice of receiving cash payments or other inducement

was never disclosed to its customers either in its advertisements or customer agreements and "fundamentally corrupted the integrity of the securities market in which [defendant] operated." Thus, plaintiff alleges, although defendant advertised [*2] low commissions, the dealers' non-disclosed payments effectively made each transaction more profitable to defendant. In dismissing the complaint, the IAS court held that the Supremacy Clause of the United States Constitution barred this action even though the customer's complaint alleges the broker's acceptance of payments in violation of state law. In so ruling, the IAS court relied heavily on a prior decision from the Hennepin County District Court in Minnesota dismissing a complaint in a case brought on behalf of Minnesota residents against another broker alleging facts virtually identical to the facts of this case. That determination was subsequently reversed by the Minnesota Court of Appeals (*Dahl v Charles Schwab & Co., 524 N.W.2d 742*), which held that "there is no conflict between Minnesota common or statutory law and federal law concerning the regulation of order flow payments" (*id. at 747*) and that "the doctrine of primary jurisdiction does not bar [plaintiffs] from asserting their actions in the state district court" (id.). The IAS court distinguished Dahl from the instant case on the ground that the plaintiffs there did not so much as suggest that the order [*3] flow payments were illegal under Minnesota law while the plaintiff here alleged that the payments paid for order flow are illegal and constitute commercial bribes in violation of New York law. In so ruling, the IAS court ignored that fact that here, as in the Minnesota case, the complaint "challenges a securities brokerage firm's retention

of order flow payments without adequate disclosure (id.)." The bulk of the complaint herein alleges violations of fiduciary duty based upon a failure to disclose the receipt of inducements for order flow. The IAS court also relied upon a then recent decision of the Supreme Court, New York County, Guice v Charles Schwab & Co. (Shainswit, J.), subsequently modified by this court (*214 A.D.2d 53*, lv granted ___ AD2d ___, December 21, 1995), which, with respect to a complaint virtually identical to the one herein, specifically addressed and rejected the defendant security broker's federal preemption and primary jurisdiction arguments.

Defendant's sole basis for distinguishing this case from Dahl and Guice is that they were decided before the October 2, 1995 effective date of a new SEC rule (SEC Rule 10b-10[a][7][iii], [*4] codified at 17 C.F.R. § 240.10b-10[a][7][iii]), which requires that a broker give a client written notification disclosing "whether any other remuneration has been or will be received and that the source and amount of such other remuneration will be furnished upon written request of such customer" and that this appeal is being heard after that date. Even assuming that federal law now authorizes payment for order flow, it did not do so retroactively.

The third cause of action was properly dismissed since, as noted in *Guice, supra, 214 A.D.2d at 56*, the Martin Act does not provide a private cause of action. (See, *CPC International, Inc. v McKesson Corp., 70 N.Y.2d 268, 519 N.Y.S.2d 804, 514 N.E.2d 116.*).

We have considered the other arguments raised by defendant in support of dismissal and find that they are without merit.

ENTERED: FEBRUARY 6, 1996

SUPREME COURT : NEW YORK COUNTY

IAS : PART 10

_____X

KENNETH H. GUICE,

Plaintiff,

-against- (Filed Oct. 7, 1994)

CHARLES SCHWAB & CO., INC.,

Defendant.

_____X

SHAINSWIT, J.:

Defendant Charles Schwab & Co., Inc. ("Schwab") moves to dismiss the complaint in this putative class action, brought, allegedly, to vindicate the rights of:

> " * * * all persons who maintain, or have maintained during the Class Period, brokerage accounts at Schwab and for whom Schwab executed transactions in securities with Schwab receiving kickbacks from the market makers with whom Schwab executed those transactions."

The "kickbacks" to which plaintiff refers are commonly known in the securities industry as "payments for order flow", a term describing payments made by dealers known as "market makers" to retail brokerage firms for directing customer orders to the market makers for execution. Plaintiff alleges that this industry wide practice, as practiced by Schwab, enriched Schwab at the expense of its customers. The complaint seeks damages for fraud, breach of fiduciary duty, conversion, breach of contract,

and violations of General Business Law §352-c and New York Penal Code §180.05.

Schwab moves for dismissal of the complaint on the grounds that (1) that is a prior pending action; (2) judicial interpretation of the claims would interfere with the primary jurisdiction of the Securities and Exchange Commission over matters affecting national securities markets, and would violate the Commerce Clause and Supremacy Clause of the United States Constitution; (3) the complaint fails to state any cause of action; (4) documentary evidence required dismissal of the claim for breach of contract; and (5) no private right of action exists for violations of the Martin Act (General Business Law §352-c) nor for violations of Penal Law §180.05.[1]

The prior pending action to which Schwab refers is entitled *Robert Orman v. Charles Schwab & Co., Inc.*, No. 93 CH 7365, a class action suit brought in Circuit Court of Cook County, Illinois, Chancery Division (the "Illinois" action). Schwab has also brought this court's attention to three separate class action suits, filed in Hennepin County District Court, Minneapolis, Minnesota, and consolidated in an amended class action complaint under the lead caption *Kirk Dahl v. Charles Schwab & Co., Inc.*, Case No. MC93-16272 (the "Minnesota" action), which also raise the issue of the alleged "kickbacks".

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[1] Plaintiff admits that no private right of action exists under the Martin Act (GBL §352-c), see *CPC International, Inc. v. McKesson Corporation*, 70 NY2d 268, and so acquiesces in dismissal of this cause of action.

The allegations of wrongdoing by defendant contained in both the Illinois and Minnesota actions mirror, for the most part, the allegations made in the present action, differing only in the inclusion of various claims based on state law and in the description of the putative classes. The Illinois complaint describes the class as all of Schwab's customers nationwide who employed Schwab; from August 12, 1988 to the present; to buy or sell securities in transactions in which Schwab received the alleged "kickback". The Minnesota class is limited to Minnesota residents. At the time the present motion was made, motions were pending in both the Illinois and Minnesota actions to dismiss the complaints.

Both motions have since been determined. The Minnesota court granted summary judgment dismissing the complaint, by a decision dated April 7, 1994, upon a finding that "application of state law to the practices in question here would violate the Supremacy Clause of the United States Constitution." The Illinois court, in a brief decision dated June 2, 1994, adopted the opinion of the Minnesota court, and dismissed the complaint upon a determination that "plaintiff's claims are preempted by federal law." In neither action was the issue of class action certification ever reached.

The existence of the Illinois action does not compel dismissal under CPLR 3211(a)(4). Dismissal of an action as a result of a prior pending action is only appropriate if a prior action exists between the same parties for essentially the same relief and involving essentially the same actionable wrong. *GSL Enterprises, Inc. v. Citibank, N.A.*, 155 AD2d 247. Even then, dismissal is not mandatory, only discretionary. *Colon v. Gold*, 166 AD2d 406, 407.

Had the class action suit in Illinois ever been certified[2] as a class action, plaintiff clearly would have fallen into the nationwide class of Schwab customers cited in the pleadings. He then would have been a party to a prior pending action involving the same claim as the present action.[3]

No class was ever certified in the Illinois action, and so plaintiff is not a party to any prior pending action. The situation is not comparable to one in which a shareholder derivative action precedes a second action brought for the same relief by another shareholder, as Schwab argues. In such a situation, the dismissal of the first action on the merits will generally bar a second derivative suit by other shareholders of the same corporation on the same cause of action. *Auerbach v. Bennett*, 47 NY2d 619, 627-628. But shareholder derivative suits, unlike class actions, "require no court authorization to be brought as such". *Tanzer v. Turbodyne Corporation*, 68 AD2d 614, 619. It is this court's opinion that the pendency of an uncertified class action cannot bar other actions by putative class members until, at least, the first action is certified as a class action.

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[2] Certification of class actions in Illinois is governed by Illinois' Code of Civil Procedure, 735 ILSC 5/2-801 *et seq.*

[3] Apparently, "opting out" of the class would not have been available to plaintiff, since under NASD and NYSE rules individual claims must be arbitrated, and only class action suits may proceed in the courts. See NASD Code of Arbitration, §12(d); NYSE Arbitration Rule 600(2).

The Supremacy Clause

The Supremacy Clause, Article VI of the federal Constitution, "prevents the states from impinging overmuch on federal law and policy." *Securities Association v. Conolly*, 883 F2d 1114, 1117, *cert. denied* 495 U.S. 956, citing to *Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 368. Pre-emption of state law by federal law is a matter of congressional intent, *Schneidewind v. ANR Pipeline*, 485 U.S. 293, 299, and may be determined by explicit statutory language, or inferred "where the pervasiveness of the federal regulation precludes supplementation by the States", *Id.* at 300. Pre-emption of state law by federal law will occur "even where Congress has not entirely displaced state regulation in a particular field * * * when it actually conflicts with federal law." *Id.* Such a conflict will be found both where it is impossible to comply with both state and federal law, or "where the state law stands as an obstacle to the accomplishment of the full purposes and objections of Congress", *Id.*; see also *Darling v. Mobile Oil Corp.*, 864 F2d 981, 985-986.

As the United States Supreme Court has noted, the "general policy" of the Securities and Exchange Act of 1934 is one of self-regulation by the various exchanges "coupled with oversight by the SEC". *Gordon v. New York Stock Exchange, Inc.*, 422 U.S. 659, 666. But this is not to say, as does plaintiff, that the SEC is relegated to the role of monitor of the national market systems. The Act contains numerous references to the SEC's rule making powers, including the Commission's ability to amend the very rules adopted by the exchanges "in furtherance of the purposes of this chapter", 15 USC §78s(c).

The Minnesota court, in determining that the class action suit interfered with the special expertise and regulatory power of the SEC, took note of a recent release of the SEC in which the Commission seeks comment on "proposed rulemaking" with regard to the practice of payment for order flow, specifically, with proposed fuller disclosure of the practice, SEA Release No. 34/33026/ October 6, 1993. The Commission, which apparently has never proposed to ban the practice, states in this release its belief that "fuller disclosure of payment for order flow practices will further competition for retail orders by enabling customers to evaluate better the markets to which their orders are routed", *Id.*

This court agrees with the Minnesota court's decision that, "[t]he need for uniformity and consistency in the regulation of national securities markets is better facilitated by allowing the SEC to utilize its expertise in resolving the underlying issues." A state court judicial determination that the practice of payment for order flow is a fraud on the broker's customer, and a breach of fiduciary and contract duties, would conflict directly with the SEC's tacit approval of the practice, and its determination that fuller disclosure alone will likely resolve the potential for misuse of the practice. Such determination would stand as an obstacle to the SEC's accomplishment of a fairly and uniformly regulated securities industry, and so cannot be permitted.

The Act's preservation of "the rights and remedies that may exist at law or equity" in addition to those provided by the Act, 15 U.S.C. §78bb(a), does not permit plaintiff to bring a state court action in conflict with federal law. The present situation is not comparable to

that in *Nader v. Allegheny Airlines, Inc.*, 426 U.S. 290, in which a common law tort action alleging fraudulent misrepresentation on the part of an air carrier in the matter of overbooking was permitted to proceed despite the fact that the air carrier's activities were regulated by the Civil Aeronautics Board. The *Nader* action did not seek compensation as a result of the overbooking – a practice which the Board was monitoring, but had not disapproved – but sought damages for fraudulent misrepresentation arising from the respondent's alleged failure to inform petitioner of the practice, *Id.* at 1982.

The *Nader* court noted that it was not faced with "an irreconcilable conflict between the statutory scheme and the persistence of common law remedies", *Id.* at 1984, because the court was not "called upon to substitute its judgment" for the agency's on the reasonableness of the practice, and the suit and statute were not "absolutely inconsistent", *Id.* at 1985. In the present case a common law tort action to determine the reasonableness of the industry wide practice of payment for order flow, in light of the SEC's monitoring of the situation for the purpose of regulation, would be absolutely inconsistent. As the Minnesota court remarked, "potentially conflicting rulings regarding these practices would transform a uniform scheme of federal regulation into a shambles."

Accordingly, the motion is granted and the complaint is dismissed.

This constitutes the decision and order of the court.

Dated: October 4, 1994

/s/ J. S. C.
J. S. C.

SUPREME COURT : NEW YORK COUNTY
IAS : PART 27

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FRANK J. EVANGELIST, JR.,

Plaintiff,

- against -

FIDELITY BROKERAGE SERVICES, INC.

Defendant.

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INDEX NO. 11150-94

Part Calender No. 8875

(Filed January 18, 1995

GAMMERMAN, J.:

Defendant Fidelity Brokerage Services, Inc. ("Fidelity") moves to dismiss the complaint, pursuant to CPLR 3211(a)(2), (5), and (7), 3013, and 3016(b).

Plaintiff Frank J. Evangelist, Jr. ("Evangelist") is a resident of New York who maintained a brokerage account with Fidelity, a discount broker. Evangelist seeks to bring a class action on behalf of "all persons who maintain, or have maintained during the Class Period [January 1, 1990 to the present], brokerage accounts at Fidelity and for whom Fidelity executed transactions in securities with Fidelity receiving kickbacks from the market makers with whom Fidelity executed those transactions." The alleged "kickbacks" are commonly referred to as "inducements for order flow," a term which alludes to the practice by which market makers or exchange specialists compensate retail brokerage firms for routing customer orders to them. According to the Securities and Exchange Commission ("SEC")'s amended Rule

10b-10(e)(9) which will become effective April 3, 1995, such inducements are:

> any monetary payment, service, property, or other benefit that results in remuneration, compensation, or consideration to a broker or dealer from any broker or dealer, national securities exchange, registered securities association, or exchange member in return for the routing of customer orders by such broker or dealer to any broker or dealer, national securities exchange, registered securities association, or exchange member for execution, including but not limited to: research, clearance, custody, products or services; reciprocal agreements for the provision of order flow; adjustment of a broker or dealer's unfavorable trading errors; offers to participate as underwriter in public offerings; stock loans or shared interest accrued thereon; discounts, rebates, or any other reductions of or credits against any fee to, or expense or other financial obligation of, the broker or dealer routing a customer order that exceeds that fee, expense or financial obligation.

In his complaint, Evangelist alleges that

> 4. Beginning at least as early as January 1, 1990, and continuing up to the present (the "Class Period"), Fidelity engaged in a course of conduct designed to enrich itself at the expense of plaintiff and other class members in a manner which breached the fiduciary relationship between principal and agent, violated the express and implied terms of the contracts between Fidelity and its customers fundamentally corrupted the integrity of the securities markets in which Fidelity operated and continues to operate, operated as the receipt of

commercial bribes in violation of § 180.05 of the New York Penal Law, and defrauded plaintiff and other members of the class in violation of common law and Section 352-c of the General Business Law of the State of New York.

5. The practice operated in a simple, albeit illegal, form: in return for cash payments and other inducements, fidelity directed its customer orders, including those of the plaintiff, to market makers who paid Fidelity the aforesaid kickbacks.

Fidelity seeks the dismissal of the complaint on the grounds that (1) application of state law to inducements for order flow would violate the Commerce and Supremacy Clauses of the United States Constitution; (2) the SEC exercises primary jurisdiction over inducement for order flow practices; (3) plaintiff's seven causes of action fail to state a claim upon which relief may be granted; and (4) plaintiff's conversion claim is barred by the applicable Statute of Limitations.

In a recent decision, *Guice v. Charles Schwab & Co.*, Index No. 100875/94 (Shainswit, J.), filed October 7, 1994, the same issues that plaintiff raises in this matter were addressed. In addition, similar issues were addressed in recent decisions by the Circuit Court of Cook County, Illinois (*Orman v. Charles Schwab & Co.*, No. 93 CH 7365, entered June 2, 1994) and by the Hennepin County District Court in Minnesota (three consolidated actions, *Dahl v. Charles Schwab & Co.*, File No. 93-16272, dated April 7, 1994). Each of these decisions dismissed the complaints on the ground that application of state law to inducement for order flow practices would violate the Supremacy Clause of the United States Constitution.

On December 7, 1994, the Minnesota Court of Appeals reversed the District court decision in *Dahl*, holding that "there is no conflict between the Minnesota common or statutory law and federal law concerning the regulation of order flow payments. Thus, an action challenging a securities brokerage firm's retention of order flow payments without adequate disclosure is not preempted by federal securities law or regulations. A state district court can therefore determine the merits of the dispute." However, the Minnesota Court of Appeals based this conclusion on the fact that "[a] review of appellants' [Dahl's] complaints reveals that appellants do not suggest that order flow payments themselves are illegal under Minnesota law or that they should be prohibited.

Such is not the case here. Evangelist clearly asserts that inducements for order flow are fraudulent, illegal kickbacks which constitute the receipt of commercial bribes in violation of New York's Penal Law. Therefore, I decline to adopt the reasoning of the Minnesota Court of Appeals, and instead accept the reasoning of the Minnesota District court with respect to the issue of federal preemption.

It is well settled that the Supremacy Clause "prevents the states from impinging overmuch on federal law and policy," *Securities Indus. Assn. v. Connolly*, 883 F2d 1114, 1117, *cert denied* 495 US 956, *citing to Louisiana Pub. Serv. Commn. v. FCC*, 476 US 355, 368. Federal preemption of state law will occur when state law "actually conflicts with federal law," *Schneiderwind v. ANR Pipeline*, 485 US 293, 299. Such conflict will be found "where the state law

stands as an obstacle to the accomplishment of the full purposes and objectives of Congress," *id.*

The Securities and Exchange Act of 1934 provides for the "oversignt by the SEC" of securities exchanges, *Gordon v. New York Stock Exchange,* 422 US 659, 666, and such oversight includes rule making powers. In accordance with its special expertise and regulatory power, the SEC has issued several Releases on the subject of inducements for order flow, including SEC Release No. 34-34902, dated October 27, 1994. In this Release, the SEC rejected the same arguments that plaintiff makes here, on the ground that they are inconsistent with the federal regulatory scheme. The SEC stated:

> The Commission invited commenters to address such alternatives as banning payment for order flow and requiring the broker-dealers to pass payment for order flow through to their customers. . . . The Commission, however, has determined that these approaches are not the appropriate regulatory response at this time. (p. 24-25)
>
> . . .
>
> The Commission believes disclosure is the appropriate response to the issues raised by payment for order flow. The Commission does not believe that all payment for order flow arrangements are against the customer's best interest and must be banned *per se* as compromising a broker's duty to seek best execution of the customer's order. . . . Additionally, the disclosures required by the new Rule and Rule amendments should mitigate concerns opponents may have that investors are unaware of a broker-dealer's order routing practices. (p. 25)

. . .

> an outright ban at this time, moreover, would represent a radical change to the industry where the payment of cash or its monetary equivalent has become widespread. In addition, banning payment for order flow has associated workability problems. If the practice of cash payment for order flow were banned, because it is only one of may forms of inducement for order flow, the Commission has every reason to believe that an attendant increase in related "soft" inducements for order flow or internalization of order flow would follow. . . . The Commission will continue to monitor developments and will consider additional regulatory steps if necessary to ensure the protection of investors. (p. 26)

Moreover, the SEC stated that it did "not believe" that a broker-dealer "violates its best execution obligation merely because it receives payment for order flow." (p. 19)

In none of its Releases has the SEC banned the practice of inducements for order flow. Rather, it has required only that certain disclosure be made to brokers' customers. It is uncontested that Fidelity complied with the SEC's disclosure requirements.

To the extent that inducements for order flow are thus permissible under federal regulation, but could be prohibited under the law of New York, a conflict exists, and such claims are preempted on the ground that "state preclusion of order flow payments would impermissibly disturb the federal SEC regulation of such practices and would frustrate the objectives of Congress as set forth in the SEC Act," *Dahl v. Charles Schwab & Co., supra,* at 5.

> A state court judicial determination that the practice of payment for order flow is a fraud on the broker's customer, and a breach of fiduciary and contract duties, would conflict directly with the SEC's tacit approval of the practice, and its determination that fuller disclosure alone will likely resolve the potential for misuse of the practice. Such determination would stand as an obstacle to the SEC's accomplishment of a fairly and uniformly regulated securities industry, and so cannot be permitted.
>
> . . .
>
> In the present case a common law tort action to determine the reasonableness of the industry wide practice of payment for order flow, in light of the SEC's monitoring of the situation for the purpose of regulation would be absolutely inconsistent [with the SEC's judgment and regulation]. As the Minnesota [district] court remarked, "potentially conflicting rulings regarding these practices would transform a uniform scheme of federal regulation into a shambles."

Guice v. Charles Schwab & Co., supra, at 6, 7.

Accordingly, it is

ORDERED that the motion to dismiss is granted and the complaint is dismissed; and it is further

ORDERED that the Clerk is directed to enter judgment accordingly.

Dated: January 12, 1995

Illegible
J. S. C.
IRA GAMMERMAN

Judgment Appealed From Dated January 25, 1995

(pp. 14-15)

SUPREME COURT OF THE
STATE OF NEW YORK
COUNTY OF NEW YORK

Index No.
111050/94

----------x

FRANK J. EVANGELIST, JR.,

Plaintiff,

- against -

FIDELITY BROKERAGE
SERVICES, INC.,

Defendant.

----------x

JUDGMENT

(Filed
January 25, 1995)

WHEREAS, a motion having been duly made to this Court by the defendant, Fidelity Brokerage Services, Inc., for an order dismissing the complaint in the above-entitled action upon the grounds that the Court lacks subject matter jurisdiction, and that the complaint fails to state a cause of action, fails to bring the claims asserted within the applicable statutes of limitations, fails to plead with sufficient particularity, and fails to plead the circumstances of fraud and breach of trust in detail, and

The motion having regularly come on to be heard at an I.A.S. Commercial Part before the Honorable Justice Ira Gammerman, and after due deliberation thereon, and the Court having granted the motion by order entered in the Office of the Clerk of the County of New York on the 18th day of January, 1995, and

NOW, upon reading and filing of defendant's Notice of Motion to Dismiss (without affidavit) dated August 18, 1994, and the copy of the Summons and Complaint, and

NOW, on motion of Brown & Wood, attorneys for defendant, it is

~~ORDERED,~~ ADJUDGED ~~AND DECREED,~~ that the complaint in the above-entitled action be and the same is hereby dismissed ~~without prejudice,~~ and it is further

~~ORDERED,~~ ADJUDGED ~~AND DECREED,~~ that the defendant recover the sum of ~~Two Hundred and Ninety and no/100~~ (~~$290.00~~) $300.00 Dollars for costs and disbursements and that the defendant have execution therefor.

Judgment signed this 25 day of January, 1995.

/s/ Norman Goodman
Clerk

Judgment creditor: Fidelity Brokerage Services, Inc.,
71 Broadway – Main Level
NY NY 10006

Judgment Debtor: Frank J. Evangelist, Jr.
5 Woodvale Lane
Huntington, NY 11743

THE CONSTITUTIONAL PROVISIONS, STATUTES AND REGULATIONS

1. FEDERAL CONSTITUTIONAL PROVISION.

The Supremacy Clause, U.S. Constitution, Article VI, clause 2, provides:

> This Constitution, and the Laws of the United States . . . shall be the supreme Law of the Land; and the Judges of every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

2. FEDERAL SECURITIES LAWS.

Section 11A of the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78k, reads in pertinent part:

> (2) The Commission is directed, therefore, having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to use its authority under this title to facilitate the establishment of a national market system for securities (which may include subsystems for particular types of securities with unique trading characteristics) in accordance with the findings and to carry out the objectives set forth in paragraph (1) of this subsection. The Commission, by rule, shall designate the securities or classes of securities qualified for trading in the national market system from among securities other than exempted securities. (Securities or classes of securities so designated hereinafter in this section referred to as "qualified securities".)

(3) The Commission is authorized in furtherance of the directive in paragraph (2) of this subsection –

(A) to create one or more advisory committees pursuant to the Federal Advisory Committee Act (which shall be in addition to the National Market Advisory Board established pursuant to subsection (d) of this section) and to employ one or more outside experts;

(B) by rule or order, to authorize or require self-regulatory organizations to act jointly with respect to matters as to which they share authority under this title in planning, developing, operating, or regulating a national market system (or a subsystem thereof) or one or more facilities thereof; and

(C) to conduct studies and make recommendations to the Congress from time to time as to the possible need for modifications of the scheme of self-regulation provided for in this title so as to adapt it to a national market system.

Section 28 of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb reads, in relevant part:

78bb. Effect on existing law

Addition of rights and remedies; recovery of actual damages; State securities commissions

(a) The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity.

Section 18 of the Securities Act of 1933, 15 U.S.C. 77r (1996) reads, in relevant part:

(c) Preservation of Authority. –

(1) Fraud authority. – Consistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.

3. RULES OF THE SECURITIES AND EXCHANGE COMMISSION.

17 C.F.R. § 240.10b-10 (promulgated 1977), Rule 10b-10, Confirmation of Transactions:

(a) It shall be unlawful for any broker or dealer to effect for or with an account of a customer any transaction in, or to induce the purchase or sale by such customer of, any security (other than U.S. Savings Bonds or municipal securities) unless such broker or dealer, at or before completion of such transaction gives or sends to such customer written notification disclosing –

* * *

(2)(i) If the broker or dealer is acting as an agent for such customer, for some other person, or for both such customer and some other person,

* * *

(7)(iv) The source and amount of any other remuneration . . . received by him in connection with the transaction: Provided, however, That if, in the case of a purchase, the broker was not

participating in a distribution, or in the case of a sale, was not participating in a tender offer, written notification may state whether any other remuneration has been or will be received and that the source and amount of such other remuneration will be furnished upon written request of such customer.

17 C.F.R. 240.11Ac1-3 (promulgated 1996)

Rule 11Ac1-3. Customer Account Statements

(a) No broker or dealer acting as agent for a customer may effect any transaction in, induce or attempt to induce the purchase or sale of, or direct orders for purchase or sale of, any subject security as defined in § 240.11Ac1-2 or a security authorized for quotation on an automated inter-dealer quotation system that has the characteristics set forth in section 17B of the Act (15 U.S.C. 78q-2), unless such broker or dealer informs such customer, in writing, upon opening a new account and on an annual basis thereafter, of the following:

(1) The broker's or dealer's policies regarding receipt of payment for order flow as defined in § 240.10b-10(e)(9), from any broker or dealer, national securities exchange, registered securities association, or exchange member to which it routes customers' orders for execution, including a statement as to whether any payment for order flow is received for routing customer orders and a detailed description of the nature of the compensation received; and

(2) The broker's or dealer's policies for determining where to route customer orders that are the subject of payment for order flow as defined in § 240.10b-10(e)(9) absent specific

instructions from customers, including a description of the extent to which orders can be executed prices superior to the best bid or best offer as defined in § 240.11Ac1-2.

4. NEW YORK STATUTORY PROVISIONS.

PENAL LAW

§ 180.05 Commercial bribe receiving in the second degree

An employee, agent or fiduciary is guilty of commercial bribe receiving in the second degree when, without the consent of his employer or principal, he solicits, accepts or agrees to accept any benefit from another person upon an agreement or understanding that such benefit will influence his conduct in relation to his employer's or principal's affairs.

Commercial bribe receiving in the second degree is a class A misdemeanor.

GENERAL BUSINESS LAW

§ 352-C. Prohibited acts constituting misdemeanor; felony

1. It shall be illegal and prohibited for any person, partnership, corporation, company, trust or association, or any agent or employee thereof, to use or employ any of the following acts or practices:

(a) Any fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale;

* * *

2. It shall be illegal and prohibited for any person, partnership, corporation, company, trust or association, or any agent or employee thereof, to engage in any artifice, agreement, device or scheme to obtain money, profit or property by any of the means prohibited by this section.

* * *

4. Except as provided in subdivision five or six, a person, partnership, corporation, company, trust or association, or any agent or employee thereof, using or employing any act or practice declared to be illegal and prohibited by this section, shall be guilty of a misdemeanor.

5. Any person, partnership, corporation, company, trust or association, or any agent or employee thereof who intentionally engages in any scheme constituting a systematic ongoing course of conduct with intent to defraud ten or more persons or to obtain property from ten or more persons by false or fraudulent pretenses, representations or promises, and so obtains property from one or more of such persons while engaged in inducing or promoting the issuance, distribution, exchange, sale, negotiation or purchase of any securities or commodities, as defined in this article, shall be guilty of a class E felony.

6. Any person, partnership, corporation, company, trust or association, or any agent or employee thereof who intentionally engages in fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale, or who makes any material false representation or statement with intent to

deceive or defraud, while engaged in inducing or promoting the issuance, distribution, exchange, sale, negotiation, or purchase within or from this state of any securities or commodities, as defined in this article, and thereby wrongfully obtains property of a value in excess of two hundred fifty dollars, shall be guilty of a class E felony.